No. 2768

United States Circuit Court of Appeals 3

FOR THE NINTH CIRCUIT

CRANE COMPANY, a Corporation,
Appellant,

vs.

FIDELITY TRUST COMPANY, Trustee, a Corporation, and WASHINGTON-OREGON CORPORATION, INDEPENDENT ELECTRIC COMPANY, a Corporation, and WILLIS D. HOAG,
Appellees.

APPELLANT'S BRIEF

Upon Appeal from the United States District Court for the Western District of Washington, Southern Division.

MAURICE W. SEITZ,
Solicitor for Appellant,

RANDOLPH W. CHILDS, MAURICE A. LANGHORNE, F. D. METZGER,
Solicitors for Appellee.

Schwab Printing Co.

No. 2768

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

CRANE COMPANY, a Corporation,
Appellant,

vs.

FIDELITY TRUST COMPANY, Trustee, a Corporation, and WASHINGTON-OREGON CORPORATION, INDEPENDENT ELECTRIC COMPANY, a Corporation, and WILLIS D. HOAG,
Appellees.

APPELLANT'S BRIEF

Upon Appeal from the United States District Court for the Western District of Washington, Southern Division.

STATEMENT.

The defendant, Washington-Oregon Corporation, at the time of the furnishing of the merchandise by the intervenor as hereinafter stated, was a corporation engaged throughout the states of Washington and Oregon in the operation of electric railways, lighting and water systems; that between the 1st of January, 1911, and the 15th of July, 1914, the intervenor, Crane Company, sold to the said Wash-

ington-Oregon Corporation water pipes, gas and water mains and other necessary equipment, upon which at the time of the appointment of the Receiver hereinafter referred to, there was owing a balance to Crane Company in the amount of $11,-146.67. It appears from the record that in May, 1911, the Washington-Oregon Corporation executed a mortgage or deed of trust to the plaintiff appellee, Fidelity Trust Company, as Trustee to secure an authorized bond issue to the amount of $5,000,-000.00, said bonds bearing 6% interest, maturing on the 1st day of April and the 1st day of November of each year. Interest was paid upon the bonds issued under said mortgage up to November 1st, 1913, the defendant corporation defaulting in the payment of interest falling due on April 1st, 1914. Suit was instituted to foreclose the mortgage because of the default in the payment of this interest, and a Receiver was appointed who took charge of the properties on July 31st, 1914. Thereafter Crane Company filed its intervening petition in said foreclosure proceedings asking that its claim to the amount hereinbefore stated be declared prior to the mortgage indebtedness and that out of the proceeds of said mortgaged property, or out of the income of said receivership, that its claim be paid. The Receiver and complainant filed their answer to the intervening petition and the cause was submitted upon a stipulated statement of facts, resulting in a finding by the district court that the intervenor's claim was not preferred except to the ex-

tent of $56.03, representing materials which were furnished during June and July, 1914, within the sixty days prior to the appointment of the Receiver.

This stipulation, which is incorporated in the record herein, admits the furnishing of the materials during the time, in the amount and of the nature stated, and admits the diversion of current income of the Washington-Oregon Corporation during the time the account accrued to the Fidelity Trust Company for the payment of interest on the bonds. It also admits the insolvency of the Washington-Oregon Corporation and the necessity of the intervenor establishing a preference over the mortgage security if it is to be paid at all. The several contentions raised by the complainant in opposition to the allowance of the claim are as follows:

1. That the materials furnished were not of a character or for a purpose that would bring them within the doctrine of preference.

2. That the claim of the intervenor was stale, having accrued more than six months prior to the aappointment of receiver.

3. That the doctrine of preferential claims is not applicable to corporations of the character of the mortgagor, being applicable only to railroads.

The above propositions practically present the questions to be determined on this appeal.

While the appellant has assigned specific errors, all may be grouped under the one proposition that the trial court erred in refusing to decree the inter-

venor entitled to a preference over the mortgage bondholders to the amount of $11,146.67. Detailed facts will appear during the course of the argument, therefore for the sake of brevity a further preliminary statement will be omitted.

POINTS AND AUTHORITIES.

I.

The basis of the doctrine of preferential claims is, that at the time of the execution of the mortgage the mortgagee impliedly agrees that the current earnings of the mortgagor will be devoted first, toward the payment of the creditors furnishing supplies and materials necessary in the operation and conduct of the business,

Moore v. Donahoo, 217 Fed. Rep. 184.

II.

Materials furnished for necessary operating and managing expense or for proper equipment and useful improvements, or materials furnished that have aided to conserve the mortgaged property and keep the same in a proper state of repair, are generally given priority over the mortgage security upon a foreclosure in equity.

Fosdick v. Schall, 99 U. S. 250.

Farmers Loan & Trust Co. v. K. C. & W. N. Ry. Co., 53 Fed. Rep. 184.

Va. & Ala. Coal Co. v. Ry. Co., 170 U. S. 355.

Union Trust Co. v. Illinois Midland Ry. Co., 117 U. S. 462.

Miltenberger v. Logansport, etc., Ry., 106 U. S. 286.

N. P. Ry. Co. v. Lamont, 69 Fed. Rep. 24.

Union Trust Co. v. Morrison, 125 U. S. 609.

Southern Ry. Co. v. Carnegie Steel Co., 176 U. S. 257.

Loveland, et al. v. Blair, 222 Fed. Rep. 210.

Union Trust Co. v. Souther, 107 U. S. 594.

III.

In determining whether or not the intervenor furnishing materials in the reliance and understanding that they would be paid out of the current earnings of the corporation, the court should take into consideration the manner and amount in which the goods were furnished, the period over which they were furnished and the manner in which they were to be paid for.

So. Ry. Co. v. Carnegie Steel Co., 176 U. S. 257.

IV.

After a diversion of the current income to the mortgage creditors has been established the mortgage creditors become obligated upon a foreclosure of the mortgage to make restoration. This is true regardless of the time within which the claim of the intervenor accrued, provided always that the claim is not barred by the statute of limitations.

Moore v. Donahoo, 217 Fed. Rep. 184.

Bellingham Bay Imp. Co. v. Fairhaven & N. W. Ry. Co., 17 Wash. 371; 49 Pac. Rep. 514.

V.

The payment of interest on the bonded debt out of the current income is a diversion within the authorities.

Burnham v. Bowen, 111 U. S. 776.

Va. & Ala. Coal Co. v. Central Ry. Co., 170 U. S. 355.

Clark v. Central Ry. & Banking Co., 66 Fed. Rep. 806.

VI.

The income of a receivership should be used in the same manner as the mortgagor would have been bound to use it, if a receiver had not been appointed. Therefore the income of the receivership should be applied toward the payment of current creditors.

Burnham v. Bowen, 111 U. S. 776.

Gregg v. Metropolitan Trust Co., 197 U. S. 182.

International Trust Co. v. Townsend Brick Co., 95 Fed. Rep. 850.

Hale v. Frost, 99 U. S. 389.

VII.

There is no so-called "six months' rule."

The only time restriction seems to be, that the claim must have accrued within some reasonable time, depending upon the circumstances of the particular case.

Farmers' Loan & Trust Co. v. Ry., 53 Fed. Rep. 187.

Trust Co. v. Morrison, 125 U. S. 591.

Southern Ry. Co. v. Carnegie Steel Co., 176 U. S. 285.

Burnham v. Bowen, 111 U. S. 776.

N. Y. Guaranty & Indemnity Co. v. Tacoma Ry. & Motor Co., 83 Fed. Rep. 367.

VIII.

The equities of Crane Company entitle it to the preference prayed for.

IX.

The doctrine of preferential claims applies to all character of public service corporations.

Ill. Trust & Savings Bk. v. O. & E. Ry. Co., 89 Fed. Rep. 236.

Reyburn v. Consumers' Gas, Fuel & Lighting Co., 29 Fed. Rep. 563.

U. S. Investment Corp. v. Portland Hospital, 40 Ore. 523; 67 Pac. Rep. 195; 56 L. R. A. 627.

Homer v. Baltimore Refrig. & Heating Co., 117 Md. 411; 84 Atl. Rep. 176.

Ellis v. Vernon Lighting & Water Co., 86 Tex. 109.

Atlantic Trust Co. v. Woodbridge Canal & Irrigation Co., 79 Fed. Rep. 39.

Reinhart v. Augusta M. & I. Co., 94 Fed. Rep. 901.

ARGUMENT.

With a view of comprehending all of the legal questions involved and for convenience of argument, I will divide the discussion into the several propositions which seem essential under the authorities to the establishment of the intervenor's claim.

I.

Basis of Doctrine.

This court is familiar with the doctrine of preferential claims in foreclosure proceedings of this character, and to indulge in a lengthy explanation of the theory upon which the doctrine is based would be superfluous. This court, in the case of *Moore v. Donahoo,* 217 Fed. Rep. 184, after reviewing the foundation of the doctrine, stated it thus:

> "The real basis upon which the preference rests is thought to be the implied understanding on the part of all parties that such debts are to be paid out of the current income before the mortgagee has any claim thereto."

It would seem, therefore, that we can approach this question on the assumption that at the time of the execution of the mortgage the mortgagee impliedly agreed that the creditors furnishing materials and supplies coming within the requisite qualification have the first claim to the income.

II.

The Nature and Character of Preferential Claims.

It would be impossible from a review of the authorities to state a definition of preferential claims that would apply in all cases. As near as we can come to accuracy will be to review the principal and leading authorities on the subject, and then apply the facts under discussion. With this idea in mind, I will review the decisions and endeavor to present to the court the various elements that appear to have been adjudged necessary in determining the class and character of claims that should be preferred above the mortgage creditors. The history of this doctrine began in the case of *Fosdick v. Schall*, 99 U. S. 250. Here the court, in defining the character and class of claims allowable, said: "For necessary operating and managing expense, proper equipment and useful improvements."

We find the same expression in a case decided in this circuit, the case of *Moore v. Donahoo,* 217 Fed. Rep. 184.

In the case of *Farmers' Loan & Trust Company v. K. C., W. & M. Ry. Co.,* 53 Fed. Rep. 187, the doctrine is stated thus:

> "Preferential debts it is commonly said are those which have aided *to conserve the property* and have been contracted within some reasonable period."

In the case of *Union Trust Co. v. Illinois Midland Ry. Co.,* 117 U. S. 462, ties, rails, turntables and

fences were considered in the way of necessary repairs and operating expenses.

In the case of *Miltenberger v. Logansport, etc., Ry.,* 106 U. S. 286, the court held that the adjustment of freight balances with other railroads had priority over the mortgage creditors, on the theory that a failure to pay the freight balances would cause, no doubt, a severance of relations, which, in turn, would cripple the road. This case alone would justify the allowance of any claims made necessary to retain and protect the franchises of defendant corporation.

In the case of *N. P. Ry. Co. v. Lamont*, 69 Fed. Rep. 24, the court held that "providing, furnishing and maintaining waiting rooms" should be considered necessary operating expenses and entitled to priority.

In the case of *Union Trust Co. v. Morrison*, 125 U. S. 609, a priority was allowed under these conditions: Morrison became surety on an injunction bond at the mortgage debtor's request to prevent the property of the company being levied upon. The court in allowing the claim priority over the mortgaged security said:

> "The ground of the claim is that a portion of the property covered by the mortgage being in peril of abstraction and loss, was rescued and saved to the mortgage by the act of the petitioner. It is denied that the property was in any peril because, as contended by the respondent, it could not have been taken upon execution by reason of the prior lien of the

mortgage. But it must be conceded that until the mortgage was enforced by entry or judicial claim, the personal property of the railroad company was subject to its disposal in the ordinary course of business, and such was liable to be seized and taken on execution for its debts. * * * Even if it would have been subject to the mortgage when taken on execution, nevertheless it could have been taken, and this would necessarily have disturbed and perhaps interrupted the operation of the road, by separating property seized from the corpus of the estate. The trustee of the mortgage might have prevented such a catastrophe, it is true, by filing a bill in foreclosure and for an injunction and receiver, but they did not choose to take this course until nearly three years afterward. On the contrary, they allowed the railroad to continue to use the property and take care of it for them and stood by and saw Morrison put his hands into the fire and rescue the rolling stock, of which they were to receive the benefit. * * * Morrison's money or the fruits of it has gone into their pockets."

In the case of the *Southern Ry. Co. v. Carnegie Steel Co.,* 176 U. S. 257, in allowing the Carnegie Steel Co.'s claim as preferred, the court defined it thus:

"Debts of a railway company contracted in the ordinary course of its business."

And further from the same opinion, page 285:

"That within this rule a debt not contracted upon the personal credit of the company, but to keep the railroad itself in condition to be

> used with reasonable safety for the transportation of persons and property and with the expectation of the parties that it was to be met out of the current receipts of the company, may be treated as a current debt."

In the case of the *Toledo Railway Co. v. Hamilton,* 134 U. S. 305, the court in effect held that a claim which could not be classed as original construction must be classed as for current expense.

In the case of the *Union Trust Co. v. Souther,* 107 U. S. 594, the court in discussing the character of claims which should be allowed, covered the subject as follows:

> "To this we adhere, and, in our opinion, the right to impose terms does not depend alone on whether current earnings have been used to pay the mortgage debt, principal or interest, instead of current expenses. * * * Many other circumstances may make such an order reasonable, and this case furnishes a striking example. The first default in the payment of interest under the mortgage occurred in October, 1873. The bondholders did not see fit to take possession, as they had the right to do, when the default had continued for six months. On the contrary, notwithstanding no payments of interest had been made, they allowed the company to operate the road and incur obligations therefor until December, 1877. This was evidently in the hope that their condition would be improved by the delay; for to effect the forbearance, they established an agency, and incurred expenses to an amount much larger than the $3,000 reimbursed by the company. Prior

> to the appointment of the receiver, the gross earnings do not appear to have been enough to pay expenses, but afterwards they yielded a very considerable surplus. There cannot be a doubt that it was for the interest of the bondholders that the road should be kept in operation, and as they did not see fit to take possession while it could only be operated at a loss, it was certainly not an abuse of judicial discretion for the court to order, as a condition of granting their application for a receiver, *that debts incurred by the company in thus protecting the security should be paid from the income of the receivership,* if, in consequence of an increase of revenue, it could be done."

As was stated in the case of *Miltenberger v. Ry.,* 106 U. S. 286:

> "Many circumstances may exist which make it necessary and indispensable to the business of the road and the preservation of the property for the receiver to pay pre-existing debts of certain classes out of the earnings of the receivership, or even the corpus of the property."

In the case of *St. Louis Trust Co. v. Riley,* 70 Fed. Rep. 36, Judge Sanborn, after a thorough review of the authorities covering the question of preferred claims, stated as follows:

> "From this brief review of the decisions of the Supreme Court bearing upon this question, we think these propositions may properly be deduced:
>
> "First. There are certain claims against the mortgaged railroad company accruing before

> the appointment of a receiver, which are entitled to a preference over a prior mortgage debt in payment out of the earnings of the railroad during the receivership and out of the proceeds of the sale of its property.
>
> "Second. It is an indispensable element of every such claim that it is founded upon *property furnished or services rendered to the mortgagor, which either preserved or enhanced the value of the security of the mortgage debt,* and thereby inured to the benefit of the mortgagee.
>
> "Third. Claims of this character have been given a preference over the mortgage debt by these decisions on one of two grounds—*either on the ground that the mortgage is a lien upon the net, and not the gross, income* of the railway company, and where that part of the income that is applicable to the payment of current expenses of operation, proper equipment and necessary improvements has been diverted to pay interest on the mortgage debt or to otherwise benefit the security, and this diversion has left claims for these expenses unpaid, *it is the province and duty of the chancellor to restore the diverted funds by taking an equal amount from the earnings of the railway company during the receivership and applying it to the payment of these claims in preference to the mortgage debt,* or on the ground that payment of the claims is necessary to preserve the mortgaged railroad and keep it a going concern."

It would seem that the theory upon which these preferences were allowed was, that inasmuch as the

income had been improperly diverted, it was no more than equitable that the bondholders should be compelled to make restoration. This theory is again announced in one of the very latest cases touching the subject, namely:

Loveland, et al. v. Blair, 222 Fed. Rep. 210.

> "The problem usually presented in such contests (meaning contests to establish preference) is whether income properly applicable to operating expenses has been diverted by the mortgagor to the payment of mortgage indebtedness and to the prejudice of claimants who have, within a limited time prior to the receivership, rendered services, furnished supplies, or the like, to the railroad, and to the enhancement alike of the property and the securities upon it. Where such a diversion is shown, the bondholders may, under an appropriate issue, be required to reimburse the fund applicable to the payment of 'debts of the income' to the extent of the diversion. This is upon the principle of restoration."

It will be noted in this case from an inspection of the receiver's reports, which are incorporated in the stipulation, that the materials furnished by Crane Company did actually enhance the value of the security and were incorporated in the mortgaged property. Furthermore, it will appear later that there was a substantial diversion of the current income toward the payment of interest on the mortgage indebtedness.

The following cases show the purposes for which claims have been allowed, and by comparison it will be seen that they follow very closely to the case at bar. I confess I am unable to differentiate. It is certain, at least, that these cases are broad enough to include the materials for which Crane Company is seeking to impress a priority:

1. In *Central Trust Company v. Wabash, et al. Ry.,* 30 Fed. 332, over $200,000 of claims were allowed for borrowed money in order to provide means for the meeting of its expenses and the keeping of its road in successful operation, and completing its line.

2. In *Trust Co. v. Clark,* 26 C. C. A. 397, 81 Fed. 269, preference was given to a claim for a gear wheel and pinion.

3. In *Manhattan Trust Co. v. Sioux City Cable Co.,* 76 Fed. 658, for power furnished a street railway.

4. In *Railroad Co. v. Wilson,* 138 U. S. 501, a preferential claim was allowed for attorneys' fees.

5. In *Manhattan Trust Co.* case, 76 Fed. 658, an allowance for an electric generator.

6. In *Cleveland C. & S. Ry. Co.'s* case, 86 Fed. 73, claim allowed for the construction of a railroad bridge.

7. In *Atkins'* case, 3 Hughes, 307 (Fed. Cas. No. 604), for moneys advanced by bondholders and stockholders to pay labor claims.

8. In *Farmers' Loan & Trust Co. v. American Waterworks Co.,* 107 Fed. 23, a claim allowed for

engines, *hydrants,* boilers, valves, etc., furnished the American Water Co. at Omaha.

9. *Farmers' Loan & Trust Co. v. Northern Pac. Ry. Co.,* 71 Fed. 245, claim allowed on account of going on an appeal bond, upon the same principle as *Morrison's* case.

10. *Penn. Mut. Life Ins. Co.'s* case, 141 Ill. 35, 31 N. E. 138, claim allowed for right of way damages.

Let us now look into the character of Crane Company's claim. For convenience in discussion, I will segregate the materials furnished into three groups:

1. Materials furnished which were used for repairs and replacements.

2. Materials that were furnished and used for service connections.

3. Materials that were purchased and used in making extensions and betterments and for the laying of the new mains to take the place of old mains.

1. The following items are included under the first heading:

Exhibit "1"	$ 26.80
Exhibit "2"	29.23
Exhibit "A-3"	95.72
Exhibit "A-4"	21.87
Exhibit "A-5"	63.82
Exhibit "A-7"	176.80
Exhibit "A-14"	149.66

Exhibit "A-15"	127.03
Exhibit "A-16"	53.44
Exhibit "A-18"	45.90
Exhibit "A-22"	18.00
Exhibit "B-4"	116.41
Exhibit "B-8"	168.55
Exhibit "B-12"	561.91
Exhibit "B-18"	16.95
Exhibit "C-1"	130.41
Exhibit "C-2"	535.28
Exhibit "C-3"	42.84
Exhibit "C-4"	111.24
Exhibit "C-6"	57.85
Exhibit "D-1"	43.44
Exhibit "D-4"	222.18
Total for repairs and replacements....	$2,815.33

There can be no question about the materials furnished and used for repairs and replacements coming squarely within the class and nature allowable as preferred claims, as reference to the authorities hereinbefore reviewed will show.

No doubt counsel will take exception to my classing under one head repairs and replacements, but in justification of this I call the court's attention to the stipulation which refers to the replacements as being necessary to replace old and worn-out pipe and connections. I draw no distinction between the word "replacements" and "repairs," as to my mind it is obvious that the purpose of replacements necessarily is to take the place of something that

has either become inadequate or out of repair. In any event, they constitute necessary current expenditures. In some instances, also, the stipulation states that the repairs and replacements were used in connection with betterments at the springs. While this is true, yet nevertheless the facts remain that it was used for repair and replacement. We doubt if there can be any question about the materials used as coming squarely within the class allowable as preferred claims. The authorities which I have hereinbefore reviewed so conclusively establish this point that I am willing to submit it without further argument.

2. The following items are included within the second heading, that is, materials which were used for the purpose of making service connections. An explanation will be made of these items, in order that the court may thoroughly understand the purpose. Quoting from the stipulation of facts:

"Exhibit "A-1" consisted of cocks, which were purchased and put in stock and used in connecting customers with the gas mains of the corporation. It is stated, however, that it is not known whether these goods were used prior to the sale of the gas plant, or whether they were sold with the gas plant, amounting to ....$ 58.23

Exhibit "A-4" consisted of 993 feet of ¾-inch black pipe which was used for the same purpose, and subject to the same observation as the above, amounting to 30.79

Exhibit "A-4," continued, consisted of galvanized pipe used to connect customers with the mains, amounting to.........	21.31
Exhibit "A-4," continued, consisted of corporation cocks used to make connections with the users of water..............	48.75
Exhibit "A-4," continued, consisted of corporation cocks, subject to the same observation as above..................	36.25
Exhibit "A-4," continued, consisted of pig lead which was used in calking pipes in extensions that were made...........	154.03
Exhibit "A-8" consisted of clamps, corporation cocks and stop cocks which were used in making connections with customers, amounting to................	110.87
Exhibit "A-9" consisted of clamps which were used for the same purposes......	9.10
Exhibit "A-10" was for soil pipe used for making curb boxes necessary in connections to customers, and also for unions used for the same purpose, amounting to	45.00
Exhibit "A-11" consisted of soil pipe and unions for the same purpose as hereinabove stated	110.14
Exhibit "A-13" consisted of tees which were used on extensions necessary to supply customers	85.50
Exhibit "A-17" consisted of couplings, nipples, valves, ells and cocks which were used in making service connections to customers	302.25

Exhibit "A-19" consisted of 2,007 feet of 2-inch galvanized pipe used for necessary extensions to connect customers......	300.08
Exhibit "A-21" consisted of clamps which were used for service connections, amounting to	25.20
Exhibit "B-1" consisted of corporation cocks for wooden pipe line used in connections to users of water, amounting to	41.76
Exhibit "B-3" consisted of fittings and other accessories used in making connections to customers................	66.78
Exhibit "B-7" consisted of small fittings and pipe used for repair and service connections	195.89
Exhibit "B-9" consisted of small fittings and clamps used for connections to customers	38.29
Exhibit "B-10" consisted of cocks and small fittings used for making service connections	79.58
Exhibit "C-5" consisted of galvanized pipe, corporation cocks and other fittings used to connect customers with mains..	173.89
Exhibit "C-7" consisted of 3,610 feet of 2-inch galvanized pipe used for laying the gas mains to connect customers and for connecting dead ends of mains in order to obtain proper circulation..........	551.11
Exhibit "C-8" consisted of corporation cocks, ells, unions and nipples used for service connections	78.59

Exhibit "D-2" consisted of 4-inch and 2-inch galvanized pipe which was used in making service extensions to supply customers with water..................	356.70
Exhibit "D-3" consisted of corporation cocks, unions, clamps and ells used in making service connections...........	171.38
Exhibit "D-5" subject to the same observation as above	176.84
Exhibit "E-1" consisted of ¾-inch galvanized pipe used entirely in making service connections to customers.........	41.72
Total used for service connections.....	$3,310.03

To recapitulate the authorities hereinbefore referred to, we have the following definition of claims allowable as preferred:

> "For necessary operating and managing expense, proper equipment and useful improvement; those which have aided to conserve the property; necessary operating expense and repair; current operating expenses; material furnished and services rendered, which preserved or enhanced the value of the securities."

With the foregoing definition as a preface, it would seem hardly necessary to indulge in a lengthy discussion of the propriety of this classification. Service connections can be classed as nothing more or less than necessary equipment or current operating expenses. In order to properly operate, it became necessary daily, no doubt, to connect applicants for water with the mains of the defendant

company. These connections were necessary to enable the corporation to perform its functions and receive its revenue, its profits necessarily depending upon the amount of water it could sell and the rate it could collect. The only means, as before stated, of delivering it was through service connections. In fact, the business could not otherwise be conducted. I submit, therefore, that nothing could be deemed more essential than the purchasing and using of the necessary equipment to make these connections. Furthermore, it is common knowledge that all public service corporations of the defendant's character uniformly operate under franchises, which compel the public service corporation, in order to retain its franchise, to serve water to the customers of the city as demanded. A strict performance of this duty is essential to the retaining and enjoyment of the franchise, which is admittedly the most valuable asset of the public service corporation. Therefore, it seems logically to follow that whatever was necessary to retain the franchise cannot be classed other than a necessary expense, in order to conserve the property of the corporation.

3. The following items are included under the third heading. These materials were used in replacing old mains and in making betterments. I will also explain these items briefly by quoting verbatim from the stipulation:

Exhibit "A-6" consisted of 6-inch Matheson pipe used in an extension of Thirty-ninth Street in the City of Vancouver.

There had been a 2-inch main on this street, but the same had proven inadequate to supply the customers, and it became necessary to lay these mains in its stead. A further extension was added to it to supply water to the shops of the S., P. & S. Ry. Co................$1,868.78

Exhibit "A-12" was a gate valve used as a necessary part of the extension above mentioned 13.61

Exhibit "A-14" consisted of a gate valve used to replace old gate valves in betterments that were made at the springs, the source of the water supply for the City of Vancouver 149.66

Exhibit "A-20" consisted of 6-inch Matheson pipe which was laid on Fourth Plains Avenue in Vancouver. The laying of this main was necessitated in order to supply the users of water and also to connect with fire hydrants, in compliance with the contract with the city. *The laying of these mains and the performance of this contract was made a condition precedent to the renewing of the franchise* 805.26

Exhibit "B-11" consisted of 4-inch and 6-inch Matheson pipe used for mains which were laid in the City of Hillsboro. In explanation of this item we call the court's attention to the fact that the franchise under which the company had operated had expired. Some of the mains of the corporation in the City of

Hillsboro were in an old, worn and leaky condition. In addition, the city desired to pave some of its streets. In the granting of the new franchise, or rather in the renewing of the old, the condition was added that the corporation replace these old mains with suitable and adequate mains. It was in compliance with this franchise and to replace the old and worn-out mains that these materials were purchased...... 1,680.04

Exhibit "B-13" consisted of fittings which were used as a necessary part of the mains and therefore subject to the same observation as above................. 28.50

Exhibit "B-14" subject to the same observation as above...................... 28.50

Exhibit "B-15" subject to the same observation as above...................... 33.95

Exhibit "B-16" subject to the same observation as above...................... 18.30

Exhibit "B-6." This was for 12-inch steel pipe in fittings which were used in crossing Dairy Creek near Hillsboro. It became necessary in compliance with the ordinance for the corporation to run a pipe line from Hillsboro to Sain Creek, a distance of about 12 miles. This main was constructed of wood pipe, but in passing under the creek, wood was deemed impracticable, and this steel pipe was used in its stead........ 392.40

Exhibit "B-2" consisted of 4-inch valves which were used on and as a necessary part of the mains hereinbefore stated..	15.39
Exhibit "B-17" consisted of valves which were used on the 4-inch and 6-inch mains above stated	78.55
Exhibit "B-5" the same as preceding item	17.10
Exhibit "E-2" was used in constructing new mains to supply the Kelso and Wallace schools in the City of Kelso. The company was operating under a franchise making it obligatory to supply said schools with water...............	186.36
Total amount of merchandise used for the above purpose................	$5,316.40

Bearing in mind still the definition hereinabove given, let us examine these items and ascertain if possible whether they measure up to the necessary qualifications. In determining this question, I submit that it is essential for the court to take into consideration the nature of the business in which the corporation was engaged. That becomes particularly necessary, as the authorities are unanimous in saying that each case must rest upon its own peculiar facts. (See *Fosdick v. Schall, supra.*) The preservation of the franchises, as before indicated, was absolutely essential to its continuing in business. Therefore the materials that were furnished in order to do the work necessary to retain them could be classed under the heading of materials furnished to conserve the property of the

corporation. It would seem that the learned judge of the District Court was under the impression that in order to justify expenditures for the purpose of retaining franchises some showing ought to have been made that a failure to perform this work would have resulted in a forfeiture. I do not believe that such a deduction is warranted. A franchise of this character is nothing more or less than a contract between a municipal corporation and a private corporation, wherein the private corporation, denominated the public service corporation, agrees to perform certain specified duties, a failure to perform which would result in a breach of the contract and subject the corporation to a forfeiture. Assuredly the public service corporation cannot assume that a violation of its contract would be ignored or that it would be justified in failing to perform until a forfeiture was threatened. The only way, I submit, to prevent the property, and particularly the rights, under its franchise from becoming jeopardized is to substantially perform. Therefore I contend that the performance of the conditions required by the franchise, the penalty for a violation of which was forfeiture, would justify any such expenditures as necessary to conserve the property. No one would contend that a party's rights under a contract were valuable if he were in default under that contract. Its value must necessarily depend upon the ability of the contracting parties to enforce it, and it is elementary

in the law of contracts that no one has any legal rights under a contract upon which he is in default.

In addition to being necessary under the franchise, the laying of these mains was but the natural normal growth of the corporation. The company operated, as will be seen from the stipulation of facts, in the towns of Chehalis, Centralia, Kelso, Kalama and Vancouver, Washington, and in Hillsboro, Oregon. Each of these cities in its normal growth would demand increasing mains. A main, for instance, that might be fully adequate on one street this year might prove and would no doubt prove wholly inadequate five years hence, and would demand a new and larger main. Mains laid under these circumstances cannot be considered other than necessary improvements and equipment, in order to conduct its business with any degree of facility. That water mains will eventually wear out is obvious, and that the only remedy is to replace is equally plain. All of the mains and extensions above stated were such, and such only, as become necessary to conserve the property of the corporation and enable it to conduct its business in keeping with the growth of the cities, and in compliance with the terms and spirit of its franchises. Furthermore, a considerable portion of the last-mentioned materials were furnished to replace old, worn-out mains. The fact that those laid in place of the old mains were larger and more adequate does not mitigate against the fact that the repairs were necessary. The specific amounts incurred for

new mains are contained in the items hereinbefore set forth, so I will not take the space to call the court's attention to it other than to refer to the classification.

Opposing counsel may make the claim, as, indeed, they did at the trial court below, that all of these expenditures for new service connections should be classed as extensions. However, I do not see any merit in that contention. Such a position would necessarily imply that every time the corporation exercised its corporate function it would be making an extension to its plant. Naturally the purchase of anything new would presumptively be an addition to the assets of the company, but all of such purchases cannot be classed as extensions, as that word is applied in cases of this character. Service connections, as before stated, are merely means of delivering the corporation's product and, as a matter of fact, constitute no value except as the same is used by a purchaser of water. To state a case analogous: If A builds a factory along the line of a railway company and the company, in order to get the freight, puts in a sidetrack and switch for the accommodation of the factory, you could not call such a spur or sidetrack an extension or a permanent improvement. If A's company dies, the sidetrack and switch are useless. It can be classed as nothing other than an operating expense.

II.

Did the intervenor sell the merchandise claimed for in reliance that it would be paid out of the current earnings of the corporation?

It seems that the above question must be answered in the affirmative in order for claims of this character to be allowed. It has not, however, been held by the authorities to be necessary to show this affirmatively. The manner of furnishing the goods, the amounts in which they are furnished, are features that have been taken into consideration in determining this point. The fact that the furnishing of these goods extended over a considerable period of time would not only imply that they were purchased for current necessities, but that it was intended that they were to be paid out of the current earnings. Also the fact that notes were subsequently taken for a portion of the amount, payable in installments at future dates, is a strong indication that it was the intention of the parties that the goods were to be paid out of the current income. I do not anticipate that any contention will be made on this point by opposing counsel. However, in proof that the manner of furnishing the goods, and the manner of payment is decisive on the proposition, I will quote from the case of *Southern Ry. Co. v. Carnegie Steel Co.*, 176 U. S. 235:

> "That whether a debt was contracted upon the personal credit of the company without any reference to its receipts is to be determined in

each case by the amount of the debt, the time and terms of payment, and all other circumstances attending the transaction."

In the above quoted case the claim was for something over $100,000, demanded from time to time. Finally notes were given for the balance due, payable at future dates. An inspection of the case will show that the situation is quite similar to the one at bar, and clearly establishes the fact that Crane Company is well within the rule.

III.

After a diversion of the current income has been shown, are creditors whose claims come within the designated class entitled to preference, regardless of time, provided they are within the period of the statute of limitations?

I answer the above query in the affirmative. The theory of allowance is that through diversion the secured creditors or bondholders have come into possession of moneys which in reality belong to the current creditors. In other words, the income of the corporation is a sort of trust fund for the benefit of the unsecured creditors. By allowing priority after a diversion has been shown, the court in effect requires the secured creditors to release this trust fund or to pay back into the fund that which they have surreptitiously withdrawn.

In the case of *Moore v. Donahoo*, 217 Fed. Rep. 184, the court held that the current income was a

trust fund for the benefit of the creditors, the exact language of the opinion being as follows:

> "If, as is thus held, the current income constitutes a trust fund, and if the mortgagee in taking his security impliedly agrees that laborers and materialmen may first be paid out of this fund before he has any claim thereto, and if one performs labor or supplies material in reliance upon this understanding, it follows, as a matter of course, that he has a right which a court of equity may assist him to enforce , or if he so desires to institute a proceeding for that purpose."

To a similar import is the case of *Union Trust Co. v. Walker,* 107 U. S. 596:

> "As we have said in *Fosdick v. Schall,* 99 U. S. 235, these creditors are paid, not because in law they have a lien on the mortgaged property or income, but because in equity the earnings of the company constitute a fund for the payment of the expenses which their claims represent before any income arises which ought to be applied to the discharge of the mortgage debt."

Therefore, if, as it seems to be conceded, the current income is a trust fund for the benefit of current creditors, there is no good reason why creditors should be estopped from asserting their right to it short of the period of limitations. To apply arbitrarily a six-months' or one-year rule is manifestly unfair. The statute of limitations should be the only just barrier. While that is arbitrary purely,

yet it is statutory law and is notice to all dealing with relation to it. It seems plain to me that the court must either recede from the position taken, that the current income is a trust fund for the benefit of current creditors, or from the position that claims accruing prior to six months before receivership are barred.

If the current income ought first to be applied to the payment of current creditors, and if the mortgagee impliedly agrees that that may be done, how in a court of equity can the mortgagee justify the retention?

In the case of *Bellingham Bay Imp. Co. v. F. & N. W. Ry. Co.*, 49 Pac. Rep. 514 (Wash.) it was urged that inasmuch as the claims sought to be preferred were beyond the six-months' period, they were not allowable. In discussing that feature of the case, the court said:

> "* * * It would seem but just that a party should, in the absence of special circumstances of controlling importance, be entitled to equitable relief for the full period in which, according to the statute, an action might be maintained at law to enforce the demand. If the lapse of three years is necessary, under the statute, to bar the debt, there appears to be no sufficient reason, generally speaking, why the equitable right should be barred within a shorter period."

This appears to be logic, as well as equity.

Another equitable feature creeps into the discussions, which the court should not be unmindful of,

and that is the bondholders are here seeking equitable relief. They asked and received at the hands of the court, in fact, extraordinary equitable relief in the appointment of a receiver. After coming into equity they ought not to be permitted to take the position that they can enforce their security and at the same time retain from the current income moneys which they had no right in the first instance to take. I cannot see how their position can be tenable, unless we are to ignore the maxim that "he who seeks equity must do equity." Therefore, I say that by application of the well-established principles of equity, as well as the theory of allowance, the court cannot escape the conclusion that in meting out to the plaintiff the equitable relief which it prays for, the court should at the same time compel the plaintiff to do equity by returning the funds wrongfully diverted.

In most cases where claims have been denied because of time, no other equities favorable to intervenor were presented. A diversion creates an equity most favorable to intervenor, as has been often held.

The case of *Clark v. Central Ry. & Banking Co.*, 66 Fed. Rep. 806, is typical, holding:

> "In this case the equities are especially favorable to the intervenors, for it appears that there was a diversion of the income for the payment of interest on bonds."

In all cases that I have reviewed where the other equities have been favorable to intervenor the question of time has been absolutely ignored.

Morrison v. Trust Co., supra.

Burnham v. Bowen, supra.

IV.

What constitutes a diversion of the income, and did diversion take place?

There was no contention made in the court below and I do not think any contention will be made here that there was no diversion. In fact, by the stipulation it was agreed, in substance, that there had been a diversion, in that the interest on the bonded debt had been paid out of the current income. (Trans. of Rec., p. 57.) By reference to the amount of the interest payable, it will be seen that diversions in this case did occur to the amount of nearly $100,000 per year during the time that Crane Company's account accrued. That the paying of interest on bonded debt is a diversion is well established by the authorities, and needs no discussion. In addition to this diversion, it is apparent from an inspection of the receiver's reports that the company's plant at some points in Washington and at Hillsboro, Oregon, was a paying investment. That is, as far as the water end of the business was concerned. These earnings were made possible, to a large extent, by the materials furnished by Crane Company. As before stated, I do not feel that there will be any contention made on this point, and I will therefore waive any further discussion, at least until the correctness of this assumption is challenged. However, the

cases cited in my Points and Authorities under this heading conclusively establish the proposition.

V.

How should the income of a receivership be used, and how was it used?

What has just previously been said about income prior to receivership is equally true as to income during receivership. If at the instance of the mortgage creditors a receiver is appointed, the receiver is bound to use the income of the receivership in the manner the corporation would have been bound to use it. In other words, the appointment of the receiver does not give the mortgagee the right to misappropriate the current earnings, and if these current earnings are misappropriated in the manner hereinbefore stated, the corpus of the estate is chargeable with the restoration of the funds. This proposition is uniformly held to by all of the leading authorities.

In *Burnham v. Bowen,* 111 U. S. 780, is found:

> "When a court of chancery, in enforcing the rights of mortgage creditors, takes possession of a mortgaged railroad and thus deprives the company of the power of receiving any further earnings, it ought to do what the company would have been bound to do if it had remained in possession; that is to say, pay out of what is received from earnings all the debts which in equity and good conscience, considering the character of the business, are chargeable upon such earnings."

Further quoting from the case, page 782:

> "So far as current expense creditors are concerned, the court should use the income of the receivership in the way the company would have been bound in equity and good conscience to use it if no change in the possession had been made. This rule is in strict accordance with the decision in *Fosdick v. Schall,* which we see no reason to modify in any particular."

Substantiating this proposition are the later cases of *Gregg v. Metropolitan Trust Co.,* 197 U. S. 182, and *International Trust Co. v. Townsend Brick Cont. Co.,* 95 Fed. Rep. 850, and *Hale v. Frost,* 99 U. S. 389.

The receiver's report shows a net income in the hands of the receiver, which he has collected, amounting to $123,091.44 (see stipulation of facts, Trans. of Rec., p. 79). If, as these authorities state, a receiver should use the fund as the corporation would have, and should have, used it, had a receiver not been appointed, he cannot escape the obligation of paying the notes representing Crane Company's claim, as they were made specific obligations, due and payable every thirty days until the total sum was paid.

Furthermore, considering the amount of the diversion, it is apparent but for that fact this obligation would have been paid. Therefore the court has the power to use this income to pay the obligations that should have been paid out of the current income.

As is stated in the case of *Fosdick v. Schall,* 99 U. S. 235:

> "It is within the power of the court to use the income from the receivership to discharge obligations which, but for the diversion of the funds, would have been paid in the ordinary course of business."

VI.

Within what time must claims accrue in order to be admitted to priority over secured creditors?

We come now to the most important phase of the discussion and the point that seems to have been decisive against the intervenor in the court below. To facilitate discussion of the subject, I will divide the intervenor's claims herein into different periods.

1. Within the six-months' period prior to receivership:

Exhibit "1"—June 24, 1914	$26.80
Exhibit "2"—July 15, 1914	29.23
	$56.03

2. Goods furnished within fifteen months prior to receivership:

Exhibit "A-14"—April 18, 1913	$ 149.66
Exhibit "A-15"—April 22, 1913	127.03
Exhibit "A-16"—May 1, 1913	53.44
Exhibit "A-17"—May 3, 1913	302.25
Exhibit "A-18"—May 9, 1913	45.90
Exhibit "A-19"—May 10, 1913	300.08
Exhibit "A-20"—May 20, 1913	805.26

Exhibit "A-21"—June 12, 1913............	25.20
Exhibit "A-22"—June 25, 1913............	18.00
Exhibit "B-18"—May 22, 1913.............	16.95
Exhibit "C- 3"—May 1, 1913.............	42.84
Exhibit "C- 4"—May 1, 1913.............	111.24
Exhibit "C- 5"—May 1, 1913.............	173.89
Exhibit "C- 6"—May 12, 1913.............	57.85
Exhibit "C- 7"—May 22, 1913.............	551.11
Exhibit "C- 8"—June 27, 1913............	78.59
Exhibit "D- 5"—April 25, 1913...........	176.84
Exhibit "E- 3"—May 6, 1913..............	1.88
	$3,038.01

3. Goods furnished within two years and three months prior to receivership:

Exhibit "A- 2"—May 9, 1912.............$	49.00
Exhibit "A- 3"—May 11, 1912.............	95.72
Exhibit "A- 4"—May 20, 1912.............	30.79
Exhibit "A- 4"—May 20, 1912.............	21.31
Exhibit "A- 4"—May 20, 1912.............	21.87
Exhibit "A- 4"—May 20, 1912.............	48.75
Exhibit "A- 4"—May 20, 1912.............	36.25
Exhibit "A- 4"—May 20, 1912.............	164.03
Exhibit "A- 5"—May 24, 1912.............	63.82
Exhibit "A- 6"—June 19, 1912............	1,868.70
Exhibit "A- 7"—June 19, 1912............	176.80
Exhibit "A- 8"—June 25, 1912............	110.87
Exhibit "A- 9"—July 1, 1912............	9.10
Exhibit "A-11"—July 16, 1912............	110.14
Exhibit "A-10"—July 10, 1912............	45.00
Exhibit "A-12"—July 17, 1912............	13.16

Exhibit "A-13"—July 23, 1912	85.50
Exhibit "B- 9"—June 4, 1912	38.29
Exhibit "B- 8"—June 26, 1912	168.55
Exhibit "B-11"—June 26, 1912	1,680.04
Exhibit "B-13"—July 1, 1912	28.50
Exhibit "B-14"—July 1, 1912	28.50
Exhibit "B-15"—July 1, 1912	33.95
Exhibit "B-16"—July 1, 1912	18.30
Exhibit "B-10"—July 12, 1912	79.58
Exhibit "B-12"—July 16, 1912	561.91
Exhibit "B- 3"—July 20, 1912	66.78
Exhibit "B-16"—July 23, 1912	392.40
Exhibit "B- 4"—July 29, 1912	116.41
Exhibit "B- 2"—July 30, 1912	15.39
Exhibit "B- 1"—July 30, 1912	41.76
Exhibit "B-17"—August 1, 1912	28.55
Exhibit "B- 5"—August 5, 1912	17.10
Exhibit "C- 1"—May 20, 1912	130.41
Exhibit "C- 2"—June 19, 1912	535.28
Exhibit "D- 1"—May 14, 1912	43.44
Exhibit "D- 2"—May 17, 1912	356.70
Exhibit "D- 3"—May 20, 1912	171.36
Exhibit "D- 4"—June 13, 1912	222.18
Exhibit "E- 1"—May 17, 1912	41.72
Exhibit "E- 2"—July 16, 1912	186.36
	$7,944.29

4. Goods furnished within three years:

Exhibit "A-1"—August 14, 1911............$58.23

5. Goods furnished within three years and three months:

Exhibit "B-7"—May 10, 1911...............$195.89

Again let me call the court's attention to the repeated injunctions in the authorities that each case must be decided, to a large extent, upon its own peculiar facts and equities. There has been no hard and fast rule establishing the time within which claims can be allowed. There is no statutory limitation, and in the absence of a statutory limitation, it is obvious that there can be no rule binding upon this court or upon any court, in fact. The six-months' rule which was invoked and applied by the trial court has never been adopted in any jurisdiction, and particularly not in this jurisdiction. Furthermore, it is generally applied, as I will show, where in the appointment of a receiver a specific provision is put in to that effect. In fact, the six-months' rule arose out of an order of that kind.

As is stated in Foster's Federal Practice (5th ed.), Volume 1, Section 305, page 962:

> "The practice arose in the Seventh Circuit to impose as a condition upon the appointment of a receiver in a suit for the foreclosure of a railroad mortgage, that debts for materials and supplies and labor furnished to the mortgagor within six previous months be paid out of the net income, or in some cases out of the proceeds of the sale of the road, before the debt secured by the mortgage. This is called the six-months' rule."

The cases are so numerous that it would be impractical and unnecessary to review many, but I will refer to what I consider the principal authorities on the question and out of which this doctrine grew, and through which it is promulgated:

Farmers' Loan & Trust Co. v. Ry., 53 Fed. Rep. 187:

> "There is no fixed rule barring preferential debts contracted more than six months before the appointment of a receiver. There is no six-months' rule."

Railroad Co. v. Lamont, 69 Fed. Rep. 23:

> "A preferential claim is not barred though contracted more than six months before the appointment of a receiver. As to such debts there is no six-months' rule, as has often been decided."

Southern Ry. Co. v. Carnegie Steel Co., 176 U. S. 285:

> "In some cases the courts in their administration of railway properties by receivers have refused to give priority to unsecured claims that did not accrue within the six months immediately preceding the appointment of a receiver. Such a rule will do full justice in most cases to creditors who are to look to current receipts for current debts, but no absolute rule on the subject has been prescribed by statute or judicial opinion. A claim accruing back of the six-months' period immediately preceding the receivership may, under the circumstances of the particular case, be accorded the same priority in the distribution of earnings that belongs to like claims arising within that period."

Perhaps there can be no more convincing argument to show that there has never been a hard and fast rule established than to cite some cases where claims have been allowed for periods greater than six months.

1. In the case of *Skiddy v. Atlantic,* 3 Hughes, 320, a claim was allowed that had accrued eight months prior to the receivership.

2. In the case of *So. Ry. Co. v. Carnegie Steel Co.,* 176 U. S. 257, and *Burnham v. Bowen,* 111 U. S. 776, claims were allowed that had accrued eleven months prior to the receivership.

3. In the case of *Farmers' Loan & Trust Co. v. Ry.,* 53 Fed. Rep. 182, and *Central Trust Co. v. Ry.,* 41 Fed. Rep. 551, claims were allowed that had accrued two years prior to the receivership.

4. In the case of *N. Y. Guaranty & Indemnity Co. v. Tacoma Rd.,* 83 Fed. Rep. 365, a claim was allowed that had accrued twenty-two months prior to the receivership. This case arose and was decided in this jurisdiction.

5. In the case of *Hale v. Frost,* 99 U. S. 389, a claim was allowed that had accrued three years prior to the receivership.

6. In the case of *Trust Co. v. Morrison,* 125 U. S. 591, a claim was allowed as preferred, a part of which had accrued more than six years prior to receivership.

Some of the above decisions I will review, in order to show the court's reasoning in allowing the claims.

In the case of *Southern Ry. v. Carnegie Steel Co., supra,* the court allowed the claim as preferred, notwithstanding that the order appointing the receiver contained the usual six-months' clause. Part of the materials for which they were claiming went to the construction of a new line of road. Furthermore, about three or four months prior to the appointment of the receiver the claim of Carnegie Steel Company was reduced to the form of notes, made payable at future dates, very similar to the case at bar.

In holding upon the question that the court was not bound by the six-months' rule, and in deciding the claim in favor of the intervenor, the court stated as follows, page 285:

> "It may be safely affirmed, upon the authority of former decisions, that a railroad mortgagee, when accepting his security, impliedly agrees that the current funds of a railroad company, contracted in the ordinary course of business, shall be paid out of the current receipts before he has any claim upon such income."

It will be seen that here the court absolutely disregards the question of time, in spite of the fact that in the order appointing the receiver the six-months' clause was added. The equities which permitted the court to allow the claims in that case were very similar to the facts presented here, and we commend this case particularly to a careful reading by the court.

In the case of *Farmers' Loan & Trust Co. v. K. C., W. & N. W. Ry. Co.,* 53 Fed. Rep. 187, Judge Caldwell, in the opinion, quotes from the case of the *Central Trust Co. v. St. Louis, W. A. & T. Ry. Co.,* 41 Fed. Rep. 551, where preferred claims were allowed extending over a period of two years prior to the receivership, and where Justice Brewer said:

> "I do not understand from the parties making the application for the receiver that there was any desire or thought of cutting off any just claims accruing *during the brief period* which elapsed since their mortgage was given, and if counsel or party had any such idea they much mistake my judgment in the premises."

This is strong language. In other words, Justice Brewer calls two years a "brief period," and clearly indicates what I have heretofore contended, that claims that have an equitable character should not be arbitrarily barred by the application of any six-months', eight-months', or any other rule.

In *Trust Co. v. Morrison, supra,* the equities of an intervening petitioner were thoroughly discussed. Here it appears that an execution was sued out and the property of the railroad company levied upon. The railway company filed a bill for an injunction and were compelled to put up a bond. This bond was furnished by Morrison. Subsequently the railway company were defeated, and Morrison became liable, and after considerable litigation, paid a considerable amount, as I remember, about $12,000, in satisfaction of the judgment. The case

is a very interesting one and touches most of the points upon which these cases are decided.

It will be noted, furthermore, that the time question is absolutely ignored by the court. The facts of the case were inquired into, and it was decided squarely upon the equities, regardless of time.

No time limit was discussed, but looking at the case from an equitable standpoint, the court saw that Morrison had come forth at a time when the property of the corporation was in peril and rescued it. This inured to the benefit of the bondholders. Applying the same equity to this case, we find that Crane Company, in Vancouver and also in Hillsboro, came forth at a time when the company was in danger of losing its franchises, when its property had become debilitated, when it was necessary to make extensions, lay new mains and otherwise comply with its franchises and secure renewals which were essential to the preservation of its property, and the properties covered by the mortgage, and rescued this property from "peril of abstraction," and by reason thereof Crane Company's money has gone into the pockets of the mortgage bondholders. In fact, Crane Company literally converted a security which was admittedly valueless into properties worth thousands of dollars. Furthermore, to magnify the inequity and add a grim irony to the situation, the mortgage bondholders were, during this time, taking and receiving money from the corporation that, under all of the authorities, equitably be-

longed to Crane Company. If, as the authorities seem to hold, this doctrine rests on the consideration of equitable principles, what possible equitable consideration would justify such a holding? To our mind it would be shocking to the most common principles of equity to allow them to reap the benefits of the materials which Crane Company have put into their properties without compensating them therefor. In the receiver's report filed herein it will be found that the estimated value of its properties is given in such an amount as to clearly indicate that what Crane Company put in increased the value of the properties more than tenfold.

Take, again, the case of *Burnham v. Bowen,* 111 U. S. 783, where claims were allowed that had accrued eleven months prior to the receivership. The court again ignores the question of time, deciding the case upon the proposition:

> "That if current earnings are used for the benefit of mortgage creditors, before current expenses are paid, the mortgage security is chargeable in equity with the restoration of the fund which has been thus improperly applied to their use."

It does not in any of the cases that I have reviewed consider time as one of the equitable essentials necessary to the allowing of claims. One of the latest cases, for instance, in which the six-months' rule is mentioned is *Gregg v. Metropolitan Trust Co.,* 197 U. S. 107.

The court stated that no question of diversion was raised. The only thing to be decided was as to whether the intervenors were entitled to priority out of the corpus of the estate. Some reason for such a decision, because the bondholders did not visibly and materially benefit by the materials furnished, neither did they take what in equity belonged to the current creditors.

Here we have the admitted facts that the bondholders, in addition to getting the benefit of the materials which Crane Company have put in, took from the corporation money which should have gone to Crane Company, and which would have been sufficient to more than pay Crane Company's claim. If, as is stated in the cases hereinbefore cited, this income constitutes a trust fund for the benefit of the current creditors, there is no reason why the elapse of a year or two should foreclose the creditors, or give the mortgage bondholders the right to retain what does not belong to them.

In the case of *N. Y., G. & I. Co. v. Tacoma Ry. & Motor*, 83 Fed. Rep. 367, a cable had been furnished to the railway company more than twenty-six months prior to the date of the receivership. A diversion was shown in the case, and in deciding that the intervenor was entitled to priority and in passing upon the question of time, the court stated as follows:

> *"Nor can it be said that there is a fixed arbitrary rule barring preferential claims that have been contracted more than six months be-*

fore the appointment of a receiver. In *Railroad Co. v. Lamont, supra,* it was said 'a preferential debt is not barred, though contracted more than six months before the appointment of a receiver. As to such debts, there is no arbitrary six-months' rule, as has often been decided.' In the case cited the indebtedness accrued more than six months before the receivership. In *Atkins v. Railroad,* 3 Hughes, 307 (Fed. Cas. No. 604), the claim was twenty-two months' old at the time of the appointment of the receiver. In the case of *Hale v. Frost,* 99 U. S. 389, the Supreme Court gave priority to a claim for materials furnished three years before the appointment of a receiver, and for which a note had been given sixteen months before the receiver was appointed. In *Burnham v. Bowen,* 111 U. S. 776, priority was given to a claim for coal supplied eleven months before the appointment of a receiver. In *Trust Co. v. Morrison, supra,* a liability incurred by the intervenor as surety for a railroad company on an injunction bond to stay the execution of a judgment at law against the company, executed more than six years before the date of the filing of the petition in intervention, was held a preferential claim. See, also, *Douglass v. Cline,* 12 Buch. 608; *Skiddy v. Railroad Co.,* 3 Hughes, 320 (Fed. Cas. No. 12,922); *Williamson Administrators v. Railroad,* 33 Grat. 624. In the case at bar the cable was delivered on *September* 17, 1892, and was placed in use on *October 24 of the same year.* The defendant motor company was solvent until December 20, 1894, and on *December 24 of that year* a

receiver was appointed by the state court to take possession and charge of the property of the company. The time that elapsed between the delivery of the cable and the appointment of the receiver by the state court would, therefore be about twenty-six months, or a little over two years."

The Supreme Court of the State of Washington has passed upon the question in a very interesting and exhaustive case, viz.:

> *Bellingham Bay Improvement Co. v. Fairhaven & N. W. Ry. Co., et al.*, 49 Pac. Rep. 514.

In this case the intervenor's right of action was for labor, supplies and materials furnished the railway company between *January, 1892,* and *August, 1893.* The receiver was appointed *February 1, 1896.* The attorneys for the receiver demurred to the complaint, one of the grounds of demurrer being that the intervenor had lost by laches any equity for preference over the mortgaged debt. The court, in passing upon the subject, reviewed a number of the federal cases, and as that portion of the opinion is brief, I quote it verbatim:

> *"We think it is correctly stated that the length of delay in asserting one's rights which will amount to laches is not subject to fixed rule, but is largely dependent upon circumstances.* The usual course of the company in the conduct of its affairs, its financial circumstances and ability to make payment, as well as the course of dealing between the parties,

must be considered in determining to what extent credit for claims of this character may be permitted to run back. In *Hale v. Frost,* 99 U. S. 389, the Supreme Court of the United States gave priority to a claim for material furnished three years before the appointment of a receiver. In *Burnham v. Bowen*, 111 U. S. 776, 4 Sup. Ct. 675, the same court gave preference to a claim for supplies furnished more than eleven months prior to the appointment of a receiver; and in *Farmers' L. & T. Co. v. Kansas City, W. & N. W. Ry. Co.,* 53 Fed. 182, it is said: 'There is no fixed rule barring preferential debts contracted more than six months before the appointment of the receiver. *There is no six-months' rule.'* And the court further says that what length of time will bar them is not clear upon the authorities, 'and depends largely upon the circumstances of each particular case.' Upon principle, it would seem but just that a party should, in the absence of special circumstances of controlling importance, be entitled to equitable relief for the *full period in which, according to the statute, an action might be maintained at law to enforce the demand. If the lapse of three years is necessary, under the statute, to bar the debt, there appears to be no sufficient reason, generally speaking, why the equitable right should be barred within a shorter period.*"

It would seem that the portion in italics is especially fitting to the case under discussion. If, as the authorities which I have previously reviewed conclusively establish, the current income is a trust fund for current creditors, and that through a diver-

sion the bondholders have inequitably come into possession of funds which do not belong to them, there is no reason why their obligation to return it should be impaired within the statute of limitations. Another significant fact in the case above quoted is, that the allowance was made from the corpus of the estate, as there was no diversion shown.

There will, no doubt, be authorities cited by counsel tending to show that there is a six-months' rule in effect. However, a close inspection of the cases will reveal the fact that the application of a six-months' rule, or any other rule, is purely arbitrary, and applies solely to the particular facts under discussion, and in most instances where no diversion of current income is shown. It will readily be seen that a case where no diversion has been shown should be tested by entirely different equity than one where a diversion is admitted. There are also cases where the six-months' rule was applied, owing to some state statute which had been followed by the Federal Court in the appointment of a receiver, and which provided for preferential claims accruing within the six-months' period prior to the receivership.

Such cases must be differentiated from the present case. In reading over the various cases where time has been a factor in the decisions I have noted particularly that the courts have always prefaced their holding by the affirmation that no six-months' rule existed, but as applied to the facts of the par-

ticular case, the six-months' time was ample. Other cases have been decided on a question of time where there were no other equities in favor of the intervenor; in fact, where the general equities were decidedly against them. Many decisions, each supported by the so-called "six-months' rule," arose in the Eighth Circuit, and for some reason or other Judge Sanborn's decisions are in direct conflict with other decisions of the Supreme and Federal Courts, because of the technical rules he applied, apparently for the benefit of the bondholders and mortgagees. It is impossible to harmonize all of the judicial utterances and conclusions set forth in the different cases decided by the Supreme Court. Some cases are decided absolutely opposed, yet to find a differentiating point is difficult. It is not surprising that the law should be in the uncertain condition in which we find it when we consider that the doctrine is not based upon any written law, but upon equitable principles which always lie within the sound judicial discretion of the chancellor having due regard for the equities of the particular case. So in the last analysis each case must be considered from its own peculiar angle, and the court in arriving at its conclusion is directed only by certain guide posts which were set early in the history of equitable jurisprudence, and which have become fundamental law.

VII.

What are the equities peculiar to intervenor's claim?

With the foregoing in mind, let me take the court over the peculiar facts in this case, with a view and purpose of showing, if possible, the equities that should appeal to the court in the decision of this case.

The materials which were furnished by Crane Co. went into and formed a part of the mortgaged security. Not only greatly enhancing the value thereof but in many instances actually reviving security that had become valueless. For instance, the Hillsboro plant. Crane Co. put into this approximately $5,000 worth of material. At the time this was furnished the franchise under which the company was operating was about to expire and its renewal was conditioned upon the replacement of the old mains and certain extensions, materials for which were furnished by Crane Co.

In Vancouver a similar condition existed where Crane Co. furnished goods to the amount of approximately $5,000. These very properties have now gone, or will go under a foreclosure sale, into the possession of the bondholders.

If they would pay to Crane Co. what the materials cost, they would then be in a position far better than had the intervenor not come to the rescue. In addition to this while these materials were being furnished the bondholders absolutely took sufficient

from the current funds of the corporation to have paid Crane Co. in full. In other words, while Crane Co. was putting materials into the corpus of the estate for the betterment and preservation of the property, which enured to the benefit of the bondholders, the bondholders in turn were reaching into the pockets of the corporation and taking money which in equity and good conscience belonged to the intervenor. This fact we want to emphasize, that the diversion during the time that this account was accruing was so flagrant as to almost impute bad faith to the bondholders. Coming into court as they have asking equitable relief, they ought to be subjected to the wholesome doctrine that he who seeks equity must do equity, and be compelled to turn back what should have long ago been paid to the current creditors. We do not think that the doctrine of laches, disregarding the equities above stated, could be or should be urged against Crane Co. They accepted from time to time payments on account in such sums as the Washington-Oregon Corporation declared its ability to make, (Trans. of Rec., p. 55), supposing that the current receipts were being exhausted in the payment of current bills. Neither can Crane Co. be placed in the same category as labor claims or material men who have furnished materials that were used neither leaving or making any visible addition to the property. Here the materials of the intervenor can actually be identified in each instance, and are invoiced and inventoried at the present time as part of the corpus of the mortgaged

estate, and are being used by the receiver in continuing the business of the corporation and in the earning of its dividends.

The court below in its opinion attempted to deferentiate the case of the *N. Y. Guaranty & Ind. Co. v. Tacoma Ry. & M. Co.*, 83 Fed. Rep. 367, by stating that the amount of the intervenor's claim was not definitely ascertained until approximately six months prior to the receivership. In answer to that I might urge with equal propriety that the intervenor's claim herein was not definitely ascertained until the execution of the notes in June, 1914, less than sixty days prior to the receivership. (Trans. of Record, p. 52.)

As opposed to these equities the appellees stand in the position of admitting all of them yet seeking to avoid their application by applying technical rules announced in decisions wherein the facts have no similarity.

For instance, in the case of *Ill. Trust & Savings Bank v. Doud,* 105 Fed. Rep. 123, a case referred to and urged with much force by counsel for the appellee, the claim there disallowed was for money borrowed that was used in the construction of a building for the purpose of engaging in an entirely new enterprise. Furthermore the man who loaned the money was the owner of the majority of the capital stock and agreed in the terms of the loan that he should not be paid out of the current revenue, until other indebtedness was paid. Could Crane Co.'s position be compared to Doud? To have given Doud

a preference would have been an injustice and would have permitted him to openly violate a specific agreement to the contrary. Any reasoning that the court may have given in this case certainly can furnish no precedent for a decision here. *Furthermore, there was no diversion of the current income in that case.* Another case urged with emphasis is that of *Roger Ballast Car Co. v. Omaha, etc., Ry.,* 154 Fed. Rep. 629. The claim there was for ballast cars furnished to this road for the purpose of ballasting. *No diversion was shown.* The ballasting might have been necessary, but to buy a large quantity of ballast cars for that purpose could not be considered an operating expense. If, as the authorities seem to hold, each case must be decided upon its own facts, this can furnish no precedent for the decision of Crane Co.'s equities. In the case of *Toledo v. Hamilton Ry.,* 134 U. S. 296, which is cited very frequently in opposition to an allowance of preferred claims, the facts and the argument wholly prove the merit of our contention. There the claim was for furnishing materials to build a dock, which was entirely new, and which was not necessary to the operation of the road, and was so held. It is obviously impossible for me to anticipate the citations of opposing counsel or to attempt to review the decisions which seem to be contrary to my contention. I do desire, however, to impress fully upon the court that the reasoning of each case must be taken with its facts. You cannot in other words expect a case where no diversion is shown to furnish a criterion for the decision

here. Neither can a case be selected as governing where the materials furnished are entirely collateral to the main business of the corporation and not a part of maintenance or operating expense, or necessary for the preservation of the properties. Neither can a case be selected where the equities are otherwise against the intervenor, such as in the Doud case. I have been able to find no case where all of the essential elements seem to be present, and where the equities of the intervenor are as strong as in the case at bar, and if the court will take the underlying theory of preferable allowances and apply it to the facts in this case, I feel confident that the result must be an allowance of the intervenor's claim.

VIII.

Character of public service corporation to which doctrine of equitable preference applies.

Opposing counsel will make the contention no doubt that this doctrine does not apply to public service corporations of the character of the defendant. In fact, the learned judge of the District Court took occasion to express his doubt as to whether or not it did apply. The reason being that he could find no authority of the United States Supreme Court establishing such a precedent. It is my contention that the doctrine undoubtedly applies to all public service corporations. The same theory underlies all public service corporations, namely, the public necessity of keeping such corporations in operation. I am unable to perceive any greater necessity

for maintaining a railway as a going concern for the benefit of the public than maintaining any other form of public service corporation. They all owe a duty to the public, and public health and safety oftentimes depends as much upon the countinance of these corporations as the continuance of a railroad. Take the defendant corporation, for instance. It had a public duty to furnish water, a necessity to the inhabitants of the several towns in which it operated. If the health, safety and continuance of the public would not demand the continuance of such a corporation even to a greater extent than the maintenance of a railroad, then the line of demarkation is altogether too finely drawn to insure substantial justice or establish a uniform doctrine. The doctrine originated in connection with a steam railroad, and if it is to apply to steam railroads only, then this doctrine will go out of existence when steam railroads vanish, which they surely must within the next decade. Usually in the application of any equitable principle the court addresses itself to the theory and substance rather than to the form, and looking at the theory there can be no distinction between the two classes of cases. However, the question should not arise here for the reason that all of these plants, including the water, gas, railway, etc., were operated as a single unit, and under one name, so literally speaking the defendant was engaged in the operation of a railroad. The fact that it was in the additional business of furnishing water would not take it without the rule, if we are looking simply at the form.

While it must be conceded that this doctrine has been applied usually to railroad corporations, yet I can find no case where the courts have refused to apply it to other forms of corporations for that reason. In fact there are a number of cases where it has been so applied.

In the case of *Illinois Trust & Savings Bank v. O. E. Ry.*, 89 Federal Reporter, 235, it was applied to a concern engaged in operating electric railways, electric light and steam heating plants.

In the case of *Reyburn v. Consumers Gas, Fuel & Light Co.,* 29 Federal Reporter, 563, the court in applying the principle to the gas company stated the doctrine as follows:

> "The doctrine of *Fosdick v. Schall*, and the subsequent cases on the same question is, that for the purpose of keeping *works of a public character* within which the *works of this company* may *properly be included* in operation, those who have given the company credit for supplies, necessary to keep the works in operation (operating supplies) are to have a lien, etc."

In the case of *U. S. Investment Corporation, et al. v. Portland Hospital,* 40 Oregon Report. 523; 67 Pacific Reporter, 195; 56 L. R. A. 627, the doctrine is interpreted by Judge Bean, as follows:

> "Where a court of chancery takes possession of a railroad or other similar property of public corporations and operates the same through a receiver, debts contracted for labor, supplies and other necessary purposes both before as well as

after the appointment of the receiver, may be made a first lien upon the income, and if that is not adequate, upon the corpus of the property, but this is an extraordinary power exercised only in cases of railroads or other like corporations of quasi public character charged with a public duty and for reasons peculiar to that character of property."

In the case of *Homer v. Baltimore Refrigerating & Heating Co.,* 117 Maryland, 411; 84 Atlantic Reporter, 176, the doctrine was applied to a refrigerating and heating company.

In the case of *Reinhart v. Augusta M. & I. Co.,* 94 Federal Reporter, 901, the doctrine was applied to a mine.

In the case of *Ellis v. Vernon Lighting & Water Co.,* 86 Texas, 109, the doctrine was applied to a water company.

In the case of *Atlantic Trust Co. v. Woodbridge Canal & Irrigation Co.,* 79 Federal Reporter, 39, the doctrine was applied to a water company.

Counsel at the hearing in the lower court stated that in the case of *Wood v. Guaranty Trust Co.*, 128 U. S. 411, it was held that the authorities have applied the doctrine to railroad corporations only. I state with emphasis that this case does not establish any ground for such a statement. It merely in passing calls attention to the fact that the doctrine had not so far been applied except in the case of railroad companies.

The case of *Reyburn v. Consumers Gas, Fuel & Light Co., supra,* to my mind touches the key note,

and that is that creditors who have given credit to the company for operating expenses and supplies for the purpose of keeping "works of a public character" in operation are entitled to a prior lien upon the current income of the corporation. Therefore I say that to take the position that the doctrine which arose and grew out of the much discussed and interpreted case of *Fosdick v. Schall* should not be enlarged so as to include all public service corporations, is to admit that the theory of the doctrine is wrong. I feel confident that this court cannot escape the conclusion, that if the intervenor herein is otherwise entitled to a preference, this corporation is clearly within the class to which the doctrine would be applicable.

In conclusion, I submit that inasmuch as this whole doctrine arose out of and is founded upon equitable principles and inasmuch as the application of the rule which has been evolved from the case of *Fosdick v. Schall* lies largely within the sound discretion of the chancellor, Crane Co.'s equities herein are such that in view of all of the circumstances entitles it to the equitable relief prayed for. I submit therefor that the decree of the District Court is erroneous and should be reversed, and that a decree should be entered in this court establishing the preference of the intervenor in the amount hereinbefore stated.

Respectfully submitted,

Maurice W. Seitz,
Solicitor for Appellant.